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May 13, 1998

Via Facsimile: (303) 231-3385
& Overnight Mail

Mr. David S. Guzy, Chief
Rules & Procedures Staff
Royalty Management Program
Minerals Management Service
Building 85, Denver Federal Center
Denver, Colorado 80225

Re: Establishing Oil Value for Royalty Due on Indian Leases
(63 FR 7089, February 12, 1998)

Dear Mr. Guzy:

Marathon appreciates the opportunity to submit the enclosed comments on MMS' recently published proposed rule for establishing oil value for royalty due on Indian leases.

Due to MMS' radical shift from valuation of oil production at the lease based on arm's-length sales and purchases in the field, Marathon cannot and does not support the proposed rule as published.

If you have any questions please contact me.

Sincerely,

Dow L Campbell

Dow L. Campbell

Enclosure

cc: The Office of Information and Regulatory Affairs
Office of Management and Budget
Attention Desk Officer for the Department of the Interior
725 17th Street, N.W.
Washington, D.C. 20503

[90982]

Marathon Oil Company
Comments on Establishing Oil Value for Royalty Due on Indian Leases
63 Federal Register 7089 - February 12, 1998

INTRODUCTION

In the February 12, 1998, Federal Register, the Minerals Management Service ("MMS") published a notice of proposed rulemaking for establishing the royalty value of oil produced from Indian leases. MMS' stated intent is to "add more certainty to valuation of oil produced from Indian leases and eliminate any direct reliance on posted prices." (63 Federal Register 7090) The public was initially given until April 13, 1998 to submit comments on the proposed rule; this deadline was subsequently extended until May 13, 1998. Marathon Oil Company ("Marathon") welcomes the opportunity to comment on this proposed rule.

As justification for proposing such a radical shift away from the current market-based valuation regulations, MMS states that "Basically, the same regulations apply to Federal and Indian leases" but "Because of the different terms of Indian leases, MMS is proposing separate rules for Indian oil valuation." (63 Federal Register 7090). These proposed regulations often mirror the federal oil valuation regulations proposed in January 1997. Marathon filed extensive comments on the problems with the January 24, 1997, notice of proposed rulemaking for federal oil valuation. Rather than repeat each and every issue and argument, and due to MMS' failure to respond to the concerns addressed by the comments of Marathon and others, Marathon incorporates by reference the comments it filed on May 27, 1997, and attaches a copy of them hereto as Exhibit 'A'.

MMS' proposal contains many fallacies and problem areas, both those common to the federal oil valuation proposal and the instant proposal, and those unique to the Indian oil valuation proposal. The more significant among these are:

A. Arm's-Length Market at the Lease

Apparently, MMS continues to believe that there is no arm's-length market at the lease. This is simply untrue, and MMS has failed to refute the facts and assertions made by Marathon, and other lessees, in comments filed in response to the federal oil valuation proposals. The best indicator of market value at the lease remains the arm's-length sales and purchases of oil in the field or area of production. Arm's-length transactions represent the price negotiated between a willing buyer and a willing seller and reflect the numerous and complicated supply and demand factors present in the market at the time and place of the transaction. MMS continues to overlook and discount this, the best indicator of market value, in its proposed valuation process. The use of comparable transactions at the lease should remain an integral element in any valuation rule for both federal and Indian production.

B. Use of NYMEX

MMS indicates that it "searched for indicators to best reflect current market prices and settled on NYMEX for several reasons". (63 Federal Register 7092). Once again, MMS has failed to consider the voluminous comments filed by Marathon and other lessees in response to the federal oil valuation proposed rulemaking. Those comments are as valid for Indian leases as they were for federal leases. NYMEX is not an accurate indicator of market value at the lease at the time and place of production and/or sale. Numerous adjustments to the NYMEX price would be required to even attempt to calculate a fair market value at the lease. The adjustments would be so numerous and complicated that it is unrealistic to use NYMEX as the starting point for valuation. Application of an annual location differential based on market center/designated area pairs and an annual quality differential based on the type of crude oil cannot possibly fairly and accurately represent the costs associated with transporting and marketing oil in today's crude oil market. Even MMS has abandoned the use of a NYMEX-based valuation methodology for most of the federal oil production under its most recent proposed rulemaking. Marathon objects to the proposed rule, which attempts to ascribe a value to crude oil at the lease by using a futures price applicable to a market several hundred miles from the point of production.

MMS has also requested comments on possible alternative market value indicators. In connection with the federal oil valuation rulemaking, Marathon has enthusiastically supported the use of benchmarks as a workable method of determining a royalty value for crude oil produced and not sold pursuant to arm's-length contracts. The same holds true for oil produced from Indian leases. The alternatives which Marathon endorsed in the federal rulemaking were contained in our comments in response to the proposals in 62 Federal Register 36030, dated July 3, 1997, 62 Federal Register 49460, dated September 22, 1997, and 63 Federal Register 6113, dated February 6, 1998. To reiterate Marathon's proposal, royalties on crude oil not disposed of at arm's-length would be valued under the following benchmarks:

1) lessee's outright sales of like-quality crude in the field or area (including sales under tendering programs),

2) lessee's, or its affiliate's, arm's-length purchases from producers at the lease or in the same field or area,

3) outright sales at arm's-length by third parties,

4) prices published by MMS reflecting the prices MMS obtained for its crude oil taken in kind, and

5) an appropriate netback methodology.

Marathon believes that this benchmark proposal would be in accordance with lease terms and MMS' long history of valuing production at or near the lease.

MMS' proposal to use the average of the five highest daily NYMEX settle prices as one of the comparison values is wholly unjustified. MMS is inconsistent in saying that NYMEX prices reflect the market value on any given day, but then proposing to utilize only the five highest prices in the course of a month to calculate the value of oil produced each day of the month. MMS' sole justification for selection of the average of the five highest daily NYMEX settle prices for a given month is that it "is in keeping with a 75th percentile major portion calculation". (63 Federal Register 7092). However, the NYMEX futures valuation calculation and the major portion value calculation are completely independent valuation methods. As proposed, MMS would compare these two values, along with the gross proceeds value, and require royalty payments to be made at the highest of the three values. It is completely arbitrary to select only the five highest prices for the NYMEX futures valuation calculation.

Additionally, if a NYMEX-based methodology is a part of a final rule for Indian oil valuation, then the NYMEX pricing calculation should be on a calendar month basis rather than on a prompt month basis.

C. Major Portion Rule

MMS' proposal on 'major portion' is seriously flawed. MMS is proposing that the 'major portion' price be established at the 75th percentile, rather than at the 50 percent plus 1 barrel of oil currently used. MMS believes the 'major portion' value at the 75th percentile from the bottom is a reasonable safeguard to assure that 'major portion' provisions of Indian leases are satisfied. (63 Federal Register 7093). MMS' rationale for modifying its 'major portion' percentage is the fact that Indians are unhappy with the current rule. MMS fails to identify any authority for this significant deviation from current practice.

The 75th percentile represents the price at or above which the top 25 percent of the oil is sold, and below which the other 75 percent is sold. Clearly, 25 percent is not the 'major portion'. The 25 percent figure reflects, more accurately, the minor portion of the sales. MMS' proposal would escalate an already inflated value for oil production from Indian leases.

Many Indian leases require value for the production to be calculated on the basis of "the highest price paid or offered at the time of production for the major portion of the oil production from the same field". (63 Federal Register 7093). However, not all Indian leases contain this requirement. Current regulations recognition this as a limitation on the implementation of 'major portion' methodology:

> For any Indian leases which provide that the Secretary may consider the highest price paid or offered for a major portion of production (major portion) in determining value for royalty purposes, ... [30 CFR §206.102(a)(2)(i)].

Any attempt by MMS to impose a 'major portion' requirement on lessees whose lease

agreements do not include specific reference to the use of a 'major portion' price for royalty purposes would be a violation of the lease agreement and beyond the legal discretion granted to the Secretary.

MMS' definition of the term 'designated area' also raises concerns. The 'major portion' lease terms only call for a comparison to prices of oil sold from the same field where the lease lands are located. However, MMS is reserving the right to consider prices on the entire Indian reservation or, potentially, in an area which is larger than the Indian reservation and larger than the field, in its calculation of 'major portion'. This is particularly troublesome in light of the fact that for the Southern Ute tribe, the reservation encompasses portions of New Mexico, Colorado, and Utah. How can MMS reasonably consider production from New Mexico, Colorado, and Utah as being in the same field? Any attempt by MMS to define 'designated area' for the purposes of its 'major portion' analysis as anything other than 'field', would be another violation of the lease agreement and beyond the legal discretion granted to the Secretary.

Also, MMS, in calculating the 'major portion' analysis price, will look not just at prices actually received but also at the adjusted NYMEX index prices reported by lessees under Section 206.52(a). For example, under this proposal a lessee must initially report royalties on the higher of NYMEX or gross proceeds. Then MMS will make the 'major portion' comparison, however, the 'major portion' prices are derived from the monthly Form MMS-2014 royalty reports which may already contain NYMEX prices. This methodology results any little, if any, of the royalties paid to Indian lessors being based on actual prices paid or offered for a given field's production. The net effect of this proposal is, quite simply, to artificially inflate the value of oil production from Indian leases.

D. Duty to Market

MMS has proposed language which would require an Indian lessee to place oil in marketable condition and market the oil for the mutual benefit of the lessee and lessor at no cost to the Indian lessor. (Section 206.53(d) at 63 Federal Register 7102). MMS continues to refer to the introduction of this additional obligation as merely a clarification. It is much more than a clarification; it is a fundamental and unlawful change in the valuation regime and contractual obligations. This issue is already the subject of litigation in connection with MMS' Gas Transportation Rule (63 Federal Register 65753) in suits filed by both the American Petroleum Institute (API) and the Independent Petroleum Association of America (IPAA).

E. Transportation Issues

The proposed rulemaking introduces two transportation issues which represent significant departures from current regulations.

First, MMS proposes to disallow the costs of moving production from the lease to the designated area boundary. (Section 206.60, 63 Federal Register 7094). This in an unjustifiable repudiation of MMS' long-standing and well-established policy of allowing transportation costs as a valid royalty deduction. In the 1988 oil valuation rulemaking MMS addressed this same issue:

> "Two Indian commenters recommended that the paragraph be modified by (1) deleting any reference to the transportation allowances because they are improper for Indian leases, and ... MMS Response: Transportation allowances are allowable under most Indian leases. It has been MMS's practice to grant such allowances. If an Indian lease restricts such allowances, then the lease terms will govern." (53 Federal Register 1197, January 15, 1988).

MMS' only support for this departure is input from Indian lessors requesting that such costs should not be permitted. (63 Federal Register 7094). However, both MMS and Indian lessors acknowledge that costs of moving production away from the designated area may be legitimate deductions. This is simply an attempt to increase royalties through the elimination of cost deductions which have long been valid under both the lease terms and MMS' current regulations. Any new Indian valuation rule must continue to allow for the deduction of all transportation-related costs, except for where the lease terms specify otherwise.

Second, MMS proposes to disallow the use of FERC-approved tariffs in non-arm's-length situations. MMS justifies this departure on the basis that it "believes that the use of actual costs is fair to lessees and that use of a FERC-approved tariff overstates allowable costs in non-arm's-length situations". (63 Federal Register 7094). MMS approaches this issue from a 'fairness' perspective. The real 'fairness' question hinges on the issue of discrimination. MMS' proposal unfairly discriminates against certain lessees solely on the basis of their affiliation with their pipeline transporter. This is an unlawful discrimination against companies with mid-stream assets.

F. Lessee Definition

MMS proposes to dramatically expand the definition of lessee to include all operating rights owners, and all affiliates of a lessee, including production, marketing and refining arms. The expanded definition includes the production, marketing and refining affiliates of a lessee, whether or not these entities make royalty payments. This creates obligations on numerous entities which never before had responsibility to comply with MMS regulations. The newly defined 'lessee' entities did not contract with the Indian lessor and should not be subject to the same record-keeping and administrative burdens as the true lessee.

G. Form MMS-4416

Proposed Form MMS-4416 raises numerous concerns. This form contains most of the same limitations and problems associated with MMS' proposed Form MMS-4415 for the federal oil valuation rulemaking; therefore, please see Marathon's and other lessees' comments regarding that form for more details. The implementation of Form MMS-4416 would impose an immense administrative burden on the entire oil industry. The form as proposed could not feasibly be completed by one individual, or even by one entity. Its completion would require the combined and concerted effort of the producer, the marketer, the seller and the buyer. Even if each and every form could be accurately and timely reported, the resulting data would be inequitable and unfair to apply to production from a different lease and at a different time in the market. As proposed it fails to offer any assurance to a lessee that the result of this process would reflect actual market conditions. Additionally, as with Form MMS-4415, the issue of confidentiality of data has remained unaddressed by MMS.

H. Sales & Volume Data

MMS' proposal requires that sales and volume data for production sold, purchased or obtained from the designated area or from nearby fields or areas be made available. (Section 206.53 at 63 Federal Register 7101). This includes sales and volume data from fee and State leases within the designated area or from nearby fields or areas. This provision, combined with the new definition of lessee, greatly expands MMS' data requirements. MMS attempts to justify its requirement for the State and fee data based on its need to determine value under the lease terms and conditions; however, MMS fails to offer any authority for this expansive requirement.

CONCLUSION

The effect of the proposed rule is to raise the royalty rate on Indian leases dually through the valuation of oil at locations far removed from the producing leases and the elimination or reduction of many long-standing and well-established deductions for the costs of transporting and marketing the oil.

Marathon respectfully suggests the current set of market-based oil valuation regulations, in conjunction with effective compliance verification by MMS, accomplishes MMS' objectives. As with the federal rulemaking, MMS' shift in valuation requirements results in abandonment of the concepts of fairness and certainty.

[90982]

Exhibit "A"

Marathon Oil Company
Comments of Proposed MMS Oil Valuation Regulations
62 FR 3742 - January 24, 1997

INTRODUCTION

In the January 24, 1997 Federal Register, the Minerals Management Service ("MMS") published a notice of proposed rulemaking for establishing the royalty value of oil produced from federal leases. MMS' stated intent is "to decrease reliance on oil posted prices and to develop valuation rules that better reflect market value." (62 FR 3742) The public was given until March 25, 1997 to submit comments on the proposed rule; this deadline was subsequently extended until May 28, 1997. Marathon Oil Company ("Marathon") welcomes the opportunity to comment on this proposed rule.

Marathon's comments on the proposed rule begin with a discussion of fairness and certainty to the federal lessee. This section focuses on the fairness and certainty of the current regulations and, contrary to MMS' assertion, demonstrates that there are numerous uncertainties with the proposed rule.

The second section of Marathon's comments addresses the assumptions made by MMS regarding the market at the lease, a lessee's duty to market production, buy/sell and exchange agreements, crude oil calls, purchases of oil, market center and spot prices, posted prices, and comparable transactions. Marathon identifies and explains fundamental errors in MMS' assumptions.

The third section of the comments discusses MMS' proposal to issue an Interim Final Rule. Marathon is strongly opposed to such an action. As discussed later in these comments, MMS is proposing a radical change in the valuation of crude oil for royalty purposes. Lessees should not be expected to allocate the significant resources needed to comply with what may be only a temporary rule.

The fourth section of Marathon's comments identifies specific problems with MMS' index pricing methodology. While Marathon explains why crude oil must be valued for royalty purposes based on the market value at the lease, should MMS adopt an index pricing methodology, it must address the many specific problems with the methodology as proposed. These problems include: NYMEX limitations, futures versus cash prices, localized markets, location/quality differentials, Form MMS-4415, transportation issues, MMS' Wyoming example, crude oil produced in Alaska, non-lessee payors, and an unclear reference in the preamble.

Finally, the fifth section of the comments proposes alternatives to the proposed rule: (a) a workable royalty in-kind program and (b) modifications to the current regulations to eliminate any perceived shortcomings.

FAIRNESS AND CERTAINTY TO THE FEDERAL LESSEE

Marathon strongly disagrees with MMS' assertion that the proposed rule would add more certainty to the process of valuing royalties due on oil produced from Federal lands. The greatest degree of certainty is attained through a method closely associated with values determined pursuant to arm's-length agreements. Furthermore, in proposing a radical shift away from the reliance on arm's-length contracts in the royalty valuation process, MMS has chosen to sacrifice the concept that its regulations should be fair to lessees.

Current Regulations

After five years of analysis and consultation with affected parties, MMS issued its current regulations in January, 1988. Underlying those regulations was MMS' finding that royalty value is best determined by the interaction of competing market forces at the lease. In support of its use of the value accruing from arm's-length contracts (i.e., the agreed-upon price negotiated between willing and knowledgeable buyers and sellers (neither of which is under undue pressure) which have opposing economic interests with respect to that transaction) as the basis for its current valuation rule, MMS listed the following reasons, all of which remain valid:

- MMS agreed that the value obtained under the terms of an arm's-length contract is well-grounded in the realities of the marketplace where the 7/8ths or 5/6ths owner strives to obtain the highest attainable price for the oil production for the benefit of itself, and the royalty owner benefits from this incentive. (53 FR 1198)

- MMS acknowledged that an arm's-length-contract-based valuation rule provides more certainty to the valuation process for lessees, along with providing lessees with a clear and equitable value on which to pay royalties. In most instances, lessees need not be concerned that MMS will establish royalty values in excess of the arm's-length contract proceeds, which would impose a hardship on lessees. (53 FR 1198)

- MMS also recognized that an arm's-length-contract-based valuation rule benefits itself and those states which assist MMS in the audit and enforcement process by giving auditors an objective basis for measuring lease compliance. (53 FR 1198)

In proposing to depart from the current regulations, MMS focuses mainly on the contention that posted prices often do not reflect market value. However, whether or not that contention has any merit, MMS and its consultants mistakenly conclude that gross proceeds accruing under arm's-length contracts do not reflect market value at the lease if such proceeds are based in whole or in part on posted prices. Market data proves that this assertion has no basis in fact.

Another reason offered by MMS in support of its proposal to abandon an arm's-length-contract-based valuation rule is the frequency of transactions between parties which are both buyers and sellers of crude oil. MMS is concerned the parties might enter into arrangements which result in value being hidden outside the four corners of the contract. However, the current regulations address this concern. For a contract to be regarded as arm's-length for the purpose of royalty valuation, MMS requires that the parties have opposing economic interests (i.e., they must be acting in their economic self-interests) regarding that contract. "The MMS recognizes that some parties may have multiple contracts with one another. This fact alone would not cause a contract to be treated as non-arm's-length. Rather, there must be some indication that the contract in question does not reflect the full agreement between the parties." (53 FR 1198) The relationship the parties to the contract may have elsewhere is not and should not be a factor when determining whether the contract at issue is arm's-length.

MMS also previously concluded that "in the vast majority of cases, gross proceeds constitute market value. In those cases where this is not true, MMS will establish an appropriate value for royalty purposes. Arm's-length sales will not be accepted without question." (53 FR 1201) So, while acknowledging that total consideration received under a negotiated arms-length agreement is the best measure of market value, MMS provided regulatory remedies for those instances where purportedly arm's-length contract prices do not reflect reasonable value. Furthermore, under the current regulations, MMS has the authority to exercise its discretion not to accept the value accruing from an arm's-length contract as the basis for royalties if there is evidence of any of the following circumstances:

a) the price does not reflect the total consideration actually transferring from the buyer to the

seller,

b) the lessee has breached its duty to market production for the mutual benefit of the lessee and lessor,
c) there is evidence of collusion between the lessee/seller and purchaser,
d) negligence was committed on the part of the lessee in negotiating the contract, or
e) the contract's pricing practices are found to be incorrect or fraudulently manipulated. (53 FR 1198-99)

In fact, not only do the current regulations permit MMS to exercise this discretion, but they go so far as to require MMS to notify a lessee when it determines that the gross proceeds accruing to that lessee pursuant to an arm's-length contract may not reflect the reasonable value of production. (30 CFR 206.102 [b][1][iii]) In any event, however, MMS must first determine that a price is unreasonable (e.g., by reviewing comparable contracts and sales attainable under 30 CFR 206.102(d)) before it is permitted to exercise this discretion. This is a more reasonable and fair approach to arm's-length valuation than the proposed rule, which arbitrarily eliminates the use of the vast majority of arm's-length agreements.

It would be grossly unfair to federal lessees if true arm's-length contracts were excluded from the royalty valuation process solely on the basis of MMS' suspicions. A price that is generally available to all sellers is a more reasonable value for a given supply of oil than an arbitrary, calculated price which may not have been obtained by any seller. To abandon this important market-based premise would compromise the reasonable balance currently maintained between allowing MMS to reject arm's-length values under specific circumstances and providing the lessee with relative certainty that its arm's-length prices are acceptable as fair market value.

The current benchmark valuation standards are based on the principle that market value is best determined through supply/demand interaction under arm's-length contracts, and arm's-length prices established under those contracts are the best measure of value. MMS alleges, however, that the current benchmark standards are in need of replacement due to their "heavy" reliance on crude oil price postings. Yet, these benchmarks clearly acknowledge the terms "posted price" and "contract price" are not to be used interchangeably for royalty valuation purposes. Unfortunately, in order to justify its proposal to severely limit the use of arm's-length contract prices, MMS ignores this critical distinction. With the exception of the second benchmark (i.e., the arithmetic average of contemporaneously posted prices), the existing benchmark standards rely on actual contract prices negotiated by willing and able buyers and sellers for the sale/purchase of significant quantities of like-quality oil. MMS' statement that crude oil postings are usually the basis for most arm's-length contract prices is true. However, this element alone in no way diminishes the ability of a negotiated, posting-based price to reflect true market value.

Furthermore, the index pricing methodology proposed for non-arm's-length transactions is not necessary in light of the flexibility MMS has under the current regulations. Moreover, it is important to recall how MMS once viewed the viability of government determined values vis-a-vis a market-based methodology. In response to critics of its benchmark standards, MMS stated that "it would be impossible for MMS to attempt to implement a procedure (for valuing royalty) where government has to make all the decisions. Such a procedure would impose a tremendous burden which would be very costly." (53 FR 1201) (emphasis added) It is apparent from the proposed valuation rule MMS has either forgotten or chosen to ignore its own aversion to creating an immense regulatory burden for both itself and lessees.

Indeed, MMS' current benchmark standards provide for the use of spot sales, net-back procedures, or any reasonable method of valuation deemed necessary by MMS in the absence of any other alternative. However, when issuing its benchmark standards, MMS stated that "the benchmarks which have higher priority (than net-back) will result in a reasonable value for royalty purposes and obviate the need to undertake a labor-intensive net-back method." (53 FR 1203) MMS reiterated this belief in its Oil and

Gas Payor Handbook-Vol. III, Sec.3-2, when it stated that "by using arm's-length contract prices, the lessee is assured some certainty in determining value for its own non-arm's-length transactions without MMS assistance or approval."

MMS has also conceded that any new oil valuation proposal "must reflect the general concepts of fair market value - the agreed-upon cash price between willing and knowledgeable buyers and sellers." (62 FR 3746) Marathon respectfully suggests the current set of market-based oil valuation regulations, in conjunction with effective compliance verification by MMS, accomplishes this objective. By proposing such a radical shift away from the current market-based valuation regulations, MMS apparently has abandoned the concepts of fairness and certainty.

Proposed Regulations

MMS' proposed rule is based on the belief of its consultants that "market conditions have changed," presumably since 1988 when the current regulations were promulgated. (62 FR 3744) This observation is ambiguous at best, and without any basis in actual market principles, as MMS' concept of "gross proceeds" (i.e., the total consideration accruing to an oil lessee for the disposition of production) means the same in 1997 as it did in 1988. During the development of the current valuation regulations, MMS expansively defined "gross proceeds" to include all consideration flowing from the buyer to the seller for the sale of production. Thus, the current regulations prevent a lessee from avoiding its royalty obligation by keeping a part of its agreement (e.g., premiums) outside the four corners of the contract. MMS has not offered any support other than its consultants' opinions for its contention that "market conditions have changed." Unless MMS can produce credible evidence of such change, MMS' conclusion is totally without support.

MMS' proposal to limit the use of a lessee's gross proceeds accruing from an arm's-length contract as the basis for valuing oil royalties would also create inequities among federal lessees. For example, the total value received from the sale of lease production by one lessee whose transaction is viewed by MMS as non-arm's-length could be identical to the value received by a second lessee pursuant to an "acceptable" arm's-length agreement. Yet MMS' proposed rule would mandate that the first lessee undertake an unduly burdensome valuation procedure that could result in a higher royalty liability on its share of lease production. Such a result would create an unfair economic disadvantage for the first lessee vis-a-vis the second lessee.

Moreover, when arguing against the establishment of a minimum value in the current regulations, MMS stated it generally did not believe establishment of such a value was "appropriate or equitable because it could result in royalty being assessed on a value greater than the lessee received under an arm's-length contract. Where an arm's-length contract operates to set the price at which the lessee can sell the production, that contract likewise should set the royalty value in most circumstances." (53 FR 1199) Does MMS now deem a minimum value to be appropriate and equitable?

ASSUMPTIONS MADE BY MMS

MMS based the proposed rule on several inaccurate assumptions, both explicit and implicit. In the following paragraphs, Marathon identifies, discusses, and dispels these fallacies regarding markets, the disposition of oil, and pricing.

MMS indicated its efforts to write the proposed rule were aided by crude oil brokers and refiners, commercial oil price reporting services, companies that market oil directly, and private consultants knowledgeable in crude oil marketing. Marathon has reviewed the information provided by MMS in response to industry's FOIA request. Apparently MMS has relied on conclusionary opinions made in various consultants' slide presentations. However, the data upon which these opinions were developed is not in the information provided.

No Market at the Lease

In its proposal, MMS has assumed there is no market at the lease and, therefore, the only valid point of commerce is at a major trading center. This assumption is false. There is a proven market at the lease, and it is illustrated by the many sales and purchases which occur within the field or area surrounding the lease. These transactions, along with the actual proceeds received for the disposition of the oil, are the best indicators of the value of the oil at the time and place of production.

Professor Joseph P. Kalt of the Harvard University Kennedy School of Government recently provided evidence of over 850,000 outright arm's-length transactions at the lease in New Mexico, Oklahoma, and Texas alone. Testifying on January 16 and 17, 1997, at the class action certification hearing in Engwall v. Amerada Hess Corporation, et al., CV-95-322, Fifth Judicial District, County of Chaves, New Mexico, Professor Kalt described a transaction database he compiled using data obtained from the course-of-business records of the eight defendant companies and two companies not named in the suit. The data provided by the companies was analyzed to verify the data did not include non-arm's-length transactions, crude oil calls, buy/sell transactions, or balancing transactions.

The database of 886,000 transactions for the period 1990-1996 proves Professor Kalt's first hypothesis, which was the existence of outright arm's-length transactions at the lease level. Professor Kalt maintains that one must look at outright arm's-length transactions under comparable supply and demand conditions to see what marketplace forces say about the value of crude oil at the lease. For example, the San Juan Basin is geographically isolated from trading centers. The area is served by a single pipeline, one refinery, and a mixed system of trucking and pipeline connections. These factors define the highly localized supply and demand influences on the market price at the leases in the area.

Professor Kalt's analysis of the arm's-length transactions in the database supported his second hypothesis regarding the influence of localized supply and demand factors and resulted in three findings. First, market valuation, as reflected in actual transactions, varies significantly with supply and demand factors specific to particular leases, crude oil, and transactions. Second, to understand the market value of a particular transaction, one must know the attributes of that transaction. And third, market valuation in actual transactions typically spans the range of posted prices; in general, lower posters have prices which are in the range of the actual market transactions at the lease.

The movement of the traditional valuation point away from the point of production to an unrelated and distant market center is a fundamental change, one that should not be made without a well reasoned and factual explanation. The statutes governing federal valuation require that royalty be paid on the value at the lease. Section 8(a) of the Outer Continental Shelf Lands Act requires the payment of royalty at a percentage "in amount or value of the production saved, removed, or sold from the lease." (43 U.S.C. §1337(a)) Similarly, the Mineral Lands Leasing Act requires the payment of royalty at a percentage "in amount or value of the production removed or sold from the lease." (30 U.S.C. §226(b)) The courts have held that royalties are payable on production "as it is produced at the well" and "leases contemplate royalty payment to be made on the original production at the well." United States v. General Petroleum Corp., 73 F.Supp. 225, 254, 258 (S.D. Cal. 1947). What federal lease permits valuation at a market center? The proposed rule fails to adequately support either the reasoning for moving the valuation point away from the lease or the use of NYMEX prices as a purported indicator of market value at the lease. It ignores the existing legitimate means of market valuation at the point and time of production in favor of a contrived value determined far from the lease.

One of the failures of the market center approach to valuation is that it does not recognize and account for many costs and risks which exist between the market center and the lease. These include gathering and handling costs such as: administrative costs (contracting/providing for transportation, scheduling of volumes, aggregating volumes, satisfying specialized customer quality preferences, division order procedures, accounting systems, and legal review), storage costs (construction/leasing

of storage facilities, scheduling volumes, and maintaining inventory), in-transit costs (loss allowances and indirect product charges), and carrying costs (linefill requirements). Also, many risks are inherent in the movement of production away from the lease. These risks include: risk of loss of the product, environmental and safety risk (spills or releases), price risk (spot market v. term market and market price fluctuation), credit worthiness of the purchaser, and performance risk (force majeure issues, capacity problems, and failure of delivery). These are substantial costs and risks which are included when the production is valued at the lease, but MMS' market center approach fails to consider them. The mere existence of marketers and resellers willing to assume these risks and costs is proof of the value added by the aggregation and marketing functions.

MMS has recognized and admitted there are costs associated with the marketing of gas and made the following statement about the costs of marketing production: "it is intuitive that one does not receive the benefit of a service without paying for the service." (*Minerals Management Service Royalty Gas Marketing Pilot - Final Report*, September 1996, pg 10.) Likewise, MMS must recognize the costs and risks associated with moving crude oil to a market center.

Duty to Market Oil

MMS proposes to modify the paragraph on the obligation to place oil in marketable condition at no cost to the Federal Government to include a duty to market the oil downstream of the lease. As support for this change, MMS states that this is consistent with several Interior Board of Land Appeals decisions. (62 FR 3746) MMS' position erroneously contends that federal lessees currently have a duty to market production at no cost to their lessor. This is not accurate, and this new obligation cannot be created by regulation. (*See*: Comments of the American Petroleum Institute on MMS Proposal for Amendments to the Transportation Allowance Regulations for Federal and Indian Leases (October 29, 1996)).

MMS cites *Walter Oil and Gas Corp.*, 111 IBLA 260 (1989), as authority for its "clarification" that the lessee has a duty to market. (62 FR 3746) This is not, however, a clarification; it is the creation of a new obligation. MMS' regulatory authority is limited by the governing statutes. Where MMS has attempted to impose royalties on something other than the value of the production saved, removed, or sold from the leased premises, the courts have declared the agency's action to be in excess of its statutory authority. (*See*: *Diamond Shamrock Exploration Co. v. Hodel*, 853 F.2d 1159 (5th Cir. 1988); *see also*: *IPAA v. Babbitt*, 92 F.3d 1248 (D.C. Cir. 1996)).

MMS has tried to equate the obligation to place production in marketable condition with the obligation to market and asserts that since the marketable condition obligation must fulfilled at no cost to the lessor, then the obligation to market must be performed for free as well. (61 FR 39934) This is not a logical conclusion, and it is inconsistent with MMS' royalty-in-kind ("RIK") program wherein MMS includes an administrative fee when it invoices small refiners for RIK oil. MMS has recognized that there is potential increased revenue generated by moving and marketing in-kind oil downstream of the lease and additionally that there are risks/costs associated with doing so. (*See*: MMS prepared slides from RIK Feasibility Workshop presented March 8, 1997).

MMS' confusion on this subject apparently is due to its assertion that the obligation to market at no cost to the lessor is simply a corollary of the lessee's existing implied obligation to market the production for the mutual benefit of both itself and its lessor. However, "mutual" does not equate to "lessee bears all costs of." The cost of marketing efforts beyond placing the production in marketable condition at or near the lease, especially the cost of marketing efforts incurred in order to obtain higher prices for the lease production many hundreds of miles away from the field or area where it was produced, is not even remotely contemplated by the marketable condition rule, either in its present form or as it has evolved throughout history. (*See*: 30 CFR §206.102).

Buy/Sell & Exchange Agreements

MMS contends arm's-length transactions are few, and, therefore, the proposed regulations would value almost all federal oil production under MMS' non-arm's-length indexing methodology. MMS includes buy/sell and exchange agreements among the transactions considered to be non-arm's-length.

Buy/sell and exchange agreements are methods of repositioning barrels; that is, a means of changing the location, quality, and/or timing of a company's crude oil supply. MMS' reason for not accepting the contract price for oil subject to an exchange agreement is that "the prices stated in an exchange agreement may not reflect actual value." (62 FR 3744) MMS has apparently decided repositioning oil off the lease by these means hides value and disqualifies the lessee from using actual gross proceeds as the basis for royalty payments. Marathon disagrees with this assertion and contends the objective of the valuation rule should be to establish market value at the lease irrespective of whether the price is also used in the buy/sell agreement.

Crude Oil Calls

MMS also presumes the price of oil sold under arm's-length contracts from leases subject to crude oil calls is suspect. Marathon disagrees. Crude oil calls at market prices are legitimate business transactions, and nothing is suspect about the price. The market price call gives the purchaser the right of first refusal to buy the oil at market price, not the opportunity to buy the oil at below market price. Also, under MMS' proposed regulations, index pricing would be used if the production is subject to a crude oil call, even if it is not exercised.

Indeed, a market price call would actually help MMS to determine market value at the lease, since it places the burden on the producer to define market value through a competitive bid process. MMS would receive the best terms available at the lease, as the producer would sell the oil to the company submitting the best bid or the party holding the call, which would have to match the best bid in order to purchase the oil.

Purchase of Oil Disqualifies Arm's-Length Transactions

The proposed rule states:

> Even if you sell at arm's-length, MMS would require you to value your oil production under the index pricing provisions discussed below if you or your affiliate also purchased *any* crude oil from an unaffiliated third party in the United States during the two years preceding the production month. (62 FR 3743)

This discriminatory provision would apply different sets of rules to competitors within an industry group based purely on the distinction that one company purchased crude oil, while the other did not. Such disparate treatment of lessees is unfair.

The mere purchase of oil anywhere in the U.S. is not indicative of whether a transaction is at arm's-length. The only true test of an arm's-length transaction is whether or not it is the result of negotiations between willing and knowledgeable parties not under undue pressure and which have opposing economic interests with respect to that transaction. This provision will prohibit most, if not all, lessees from using the actual value of the oil at the lease and force them to use an imputed netback price. It could prove detrimental to producers who need to purchase crude oil to meet a contractual obligation, for fractionation purposes, or to blend with produced oil in order to meet pipeline specifications. Also by this logic, even the sales contracts executed by a company who has only purchased oil from the U.S. Strategic Petroleum Reserve would be deemed non-arm's-length under the proposed rule.

Along with its untenable assumption that the mere purchase of oil makes all sales suspect, this provision raises several critical and unanswered questions:

- How is the term "purchase" defined by MMS for the purposes of this provision?
- In situations where an operator sells the non-operator's share of production under its contract and then pays the non-operator, is the operator considered to have purchased the non-operator's crude?
- Does this provision apply to the purchase of foreign crude, or just domestic crude?
- Why were different types of crude oil not treated independently? There are numerous grades, types, and qualities of crude oil, and yet this rulemaking does not address the fact that a lessee may sell all of its production of one quality and purchase oil of another quality.
- Why did MMS treat the entire nation as one market? A company could purchase crude oil in one region of the country and sell all of its production in another area.
- What is the basis for the two year time frame proposed by MMS? Two years is an excessive time frame with no economic basis. Without any supporting analysis for the two year time frame, it appears arbitrary and capricious.

Market Centers & Spot Prices

MMS assumes most oil is sold at market centers. This is not Marathon's practice or experience. Market centers are not locations where all producers take oil to sell and all refiners go to obtain refinery supplies. In fact, refiners prefer to enter into long-term contracts at the lease to insure adequate refinery feedstocks, and producers must pursue long-term transportation and marketing arrangements because of the administrative burdens, the limited storage facilities and the measurement requirements associated with moving crude oil away from the lease. For this reason, the lease market is a term market. Across the country there are very active, competitive markets at the lease/field level for the sale and purchase of crude. Producers and refiners enter into negotiated agreements under which they hope to buy and sell oil for a term which can span a few months or the life of a field.

Generally market centers are trading locations for incremental barrels where short-term (month to month) shortages and overages are balanced out. Daily assessments, such as Platts, reflect the spot market value for a small portion of the crude supply traded on any given day. MMS apparently assumes all producers can or should receive a spot market center price. All producers do not have equal access to market centers, and it is unfair to value a producer's crude oil by reference to spot market prices that likely could not be obtained. Therefore, spot market prices should not be used to impute market value for the term lease market.

Posted Prices

MMS contends the NYMEX market, not posted prices, reflects value in today's marketplace. MMS states that "today's oil marketing is driven largely by the NYMEX market" (62 FR 3746) and posted prices "no longer relate to how most crude oil is marketed." (62 FR 3743) Although NYMEX is a factor in the oil market today, Marathon does not agree posted prices are an obsolete method of marketing or valuing crude oil at the lease. There is a relationship between NYMEX and posted prices, but the relationship varies depending on market conditions. Oil is generally sold at the lease using posting-based prices, and this would not be the case if posted prices were not market responsive and competitive.

Professor Kalt also testified posted prices are not arbitrary and meaningless. He based this conclusion on his study of over 850,000 arm's-length transactions at the lease which found that posted prices

lie in the range of actual market transactions. Furthermore, Professor Kalt stated that posted prices are not dominated by any company or group of companies, as evidenced by the many types of companies posting prices. There is no barrier to entry in the process of posting; a posted price is a public announcement to the marketplace that a party seeks to purchase crude oil at the lease.

Posted prices represent the base price for a specific grade of crude produced from a specific field or producing area. Prices are posted not only by integrated oil companies, but also by independent refiners and marketers such as Koch, Scurlock, and EOTT. Posted prices track NYMEX rather closely, and they reflect market value or can serve as the basis for calculating market value. Posted prices must be competitive and market responsive if a company is to be successful in purchasing crude. The posted price is used by buyers and sellers to negotiate absolute prices which may include adjustments for gravity and/or premiums. Market premiums are added to the posted price and paid to producers when a purchaser is willing to pay more than the gravity-adjusted posted price at the lease. Premiums vary in amount depending on location, volume, grade, and type of crude. Premiums are driven by competition and are negotiated on an arm's-length basis between producers and purchasers taking highly localized supply and demand factors into consideration and thereby defining the market value of crude oil in the field.

Marathon establishes a fair market value at the lease for its equity production based on comparability of arm's-length sales prices for like-quality crude oil. Knowledge of sales prices is obtained through posted price comparisons, outright sales of production at the lease, outright purchases of lease crude, and through unsuccessful bids to purchase lease crude. By actively and aggressively buying and selling crude at the lease, Marathon obtains ongoing market price information which is then used to value Marathon's own production. Marathon participates in the practice of paying premiums, and Marathon has a program of regularly reviewing the pricing on each lease to ensure the posted price plus any applicable premium represents fair market value.

Marathon does not contend posted prices alone always reflect the total value of crude oil at the lease in today's market, and thus the procedures described in the previous paragraph were established to determine that value. Marathon recognizes its obligation under the existing MMS regulations to pay royalty on the fair market value of the production. Therefore, market premiums, based on comparable sales and purchases at the lease, are included in the valuation of Marathon's production for royalty purposes regardless of the ultimate disposition of the crude. This practice is followed for crude oil disposed of or repositioned via outright sales, buy/sell or exchange agreements, and crude transported from the lease via pipeline.

Comparable Transactions

Another one of MMS' assumptions is that comparable transactions at the lease are not available or valid. This is not the case. There is ample evidence of comparable transactions (i.e., arm's-length sales and purchases of like-quality crude in the field or area). Such actual information should be used when available.

MMS suggests the use of comparable transactions be eliminated because the benchmarks under the existing regulations "rely heavily on posted and contract prices. Since many contract prices are tied to postings, the influence of posted prices is magnified." (62 FR 3744) The mere fact that a posted price has been used in arriving at a true arm's-length price should not disqualify that transaction from being considered arm's-length. If the buyer and seller are unaffiliated, have opposing economic interests with respect to the particular transaction and are free of duress, the use of a posted price is not only indicative of market value, it may be the best indicator of market value.

Arm's-length transactions may include a price basis other than a posted price. However, all arm's-length transactions in the field or area should be considered regardless of the price basis: posted price, P-Plus, NYMEX, fixed and flat, or some other basis. MMS should also take into account other relevant

matters, including information submitted by a lessee concerning circumstances unique to a particular lease operation or the salability of certain types of oil. By doing so, MMS can be assured that royalty is paid on the fair market value of the crude at the time and place of production.

INTERIM FINAL RULE PROPOSAL

The proposed rule solicits comments on the issuance of an Interim Final Rule. As proposed, this new valuation scheme would require substantial reconfiguration of systems and the management, comprehension, and manipulation of significant amounts of additional information. In spite of this monumental transition, MMS is suggesting adoption of an Interim Final Rule which might be in effect only briefly. Lessees should not be forced to make massive investments to comply with an Interim Rule, and then incur yet more costs to comply with a final rule. The idea of issuing an interim rule should be quickly discarded.

MMS also proposes to study whether the values calculated under the rule reflect actual market prices during the first six months after the effective date of the rule. Marathon is uncertain as to how this verification would be done. That is, what would MMS use as the basis of the comparison of prices/values? MMS should provide clarification regarding this proposed analysis. Indeed, it would make far more sense for MMS to analyze the likely impact of its rule by comparing prices actually reported for a historical period (e.g., 1996) to the prices calculated using the proposed methodology before it imposes its methodology on thousands of lessees. For a proposal as significant as this, MMS must determine if its methodology is workable before it imposes huge transition costs on lessees.

SPECIFIC PROBLEMS WITH THE PROPOSED MMS METHODOLOGY

Marathon strongly believes that crude oil should be valued for royalty purposes based on the market value at the lease. However, should MMS choose to implement index pricing, Marathon offers the following comments regarding specific problems with MMS' proposed methodology.

NYMEX Limitations

The starting point of MMS' indexing methodology is the average of the daily NYMEX futures settle prices for the Domestic Sweet Crude Oil contract for the prompt month. Two of the reasons given by MMS for choosing NYMEX were that "it represents the price for a widely traded domestic crude oil" (62 FR 3745) and that "NYMEX prices were regarded by many of the experts MMS consulted to be the best available measure of market value." (62 FR 3745) However, there are significant problems with utilizing NYMEX prices to value crude oil at the lease.

The NYMEX contract used by MMS only trades on light, sweet crude oil at one location (Cushing, Oklahoma) in contracts of 1,000 barrels. This is a paper market, and only about 1% of the crude contracts traded on the New York Mercantile Exchange are actually delivered as "wet barrels." NYMEX is a futures price and a barometer for world crude prices, but it is not an indicator of market value at the lease at the time and place of production and/or sale. As a result of these limitations, MMS is forced to make unrealistic "adjustments" to the NYMEX price in an attempt to value production at the lease. This is in contrast to the actual physical market at the lease where thousands of barrels are bought and sold daily and market value is readily obtainable without the need for adjustments.

Other problems arise from the use of the average of daily settle prices. First, the settle price does not reflect the transactions made throughout the trading day. An event occurring five minutes before the market closes could cause a significant swing in the price. As a result of such an event, the settle price could be much higher or lower than trades made throughout the rest of the day. Also, the use of average monthly prices would automatically replace ticket date prices with equal daily quantity

(EDQ) pricing. This may simplify the pricing process, but it fails to reflect a producer's ability to obtain "market price" at the time the oil is actually sold. This could especially impact small producers selling trucked barrels once or twice a month.

Another problem with using NYMEX-based index pricing is there are times when the Cushing market "disconnects" from other crude markets. A disconnect can be caused by disruptions in the pipeline systems in and out of Cushing, unexpected inventory swings, or paper strategies that have no relationship to domestic barrels. These disconnects may or may not have any impact on the crude markets in other geographic locations.

Finally, the use of NYMEX prices overlooks the fact that oil can be sold under a term contract. MMS is suggesting that it is somehow improper for a lessee to enter into a term contract, yet it may be detrimental to the lessee and MMS to use a spot price, especially in a downward market. Locking in a term price could be the best business decision for both the lessee and MMS.

Futures vs. Cash Prices

The second step in MMS' indexing methodology is to "derive a NYMEX price at the market center by adjusting the NYMEX price at the index pricing point to the general quality of crude typically traded at the market center, and otherwise to reflect location/quality value differences at the appropriate market center." (62 FR 3747) This use of the NYMEX price with adjustments for location/quality differentials results in an inconsistent mix of futures and cash prices to calculate a market center price. In explaining the search for indicators to best reflect market prices, MMS states "spot prices offer the advantage that they are published for several different locations and might involve somewhat less difficult adjustments." (62 FR 3745) Despite this observation, MMS proposed NYMEX, a futures price, primarily because it was perceived to best reflect current domestic crude market value on any given day. However, MMS quickly defaulted to cash prices for determining quality/location differentials. The result is an inconsistent mix in MMS' valuation methodology.

For example, under the NYMEX-based index pricing method, the production month value is based on the prompt NYMEX contract that is in effect for about 21 days (70%) of the production month. The location/quality differentials for the production month are based on the prompt spot assessment for the production month which is in effect for about 25 days (83%) of the production month. In the example cited by MMS, the WTI Cushing average spot price was $23.46 (Appendix D) and the NYMEX average settle price was $23.13 (Appendix B). The variation in the timing of each index will cause differences in the respective index values, but the differences should theoretically cancel out over time. However, even though the index value differences may average out over time, lease volumes vary from month to month, and the gross value for any given lease will be skewed over time.

Localized Market

MMS is also inconsistent in the way localized markets are treated under the proposed regulations. MMS proposes a different procedure for California and Alaska because it recognizes the geographical isolation of these markets and "believes a more localized market indicator would better represent royalty value." (62 FR 3745) MMS also recognizes the great difficulties in "making meaningful adjustments from the NYMEX price." (62 FR 3745) However, MMS fails to acknowledge there are other areas of the country which are also geographically isolated from the six locations it considers to be market centers.

The most glaring example of this is Wyoming. As discussed in detail later in these comments, the Wyoming example put forth by MMS is ludicrous. MMS proposes to value Wyoming Sour crude at a Midland, Texas price for West Texas Sour crude. In order to derive a reasonable market value for Wyoming crude, MMS must look to the market at the lease in Wyoming rather than Midland, a market

center more than 900 miles away. In fact, it is physically impossible to move oil from Wyoming to Midland via pipeline.

Inherent variables and complexities exist and need to be considered when marketing different types and grades of crude oil in separate and, to a large degree, geographically isolated market areas. In particular, the cost of transporting oil from one geographical area to another is often prohibitive, thereby effectively insulating the markets from each other in such a way that cannot be accurately reflected in the form of a "differential." Additionally, the quality of certain crude types, particularly those having extremely high or low specific gravity or those containing high concentrations of sulfur, effectively isolates the market for those crudes due to transportation and/or processing complexities.

Location/Quality Differentials

Under MMS' proposed methodology, the NYMEX-based index price would be adjusted by location/quality differentials to reflect the differences in value between Cushing and the market center and between the market center and the aggregation point. As described below, there are significant problems with both of these adjustments as proposed by MMS.

Cushing v. Market Center

The location/quality differential between Cushing and the market center would be based on the difference between the two spot price averages. Most of the published spot market prices originate from resellers. The mere existence of these resellers indicates the risk involved in moving crude from the lease to the market center and the value added to the crude by the aggregation and marketing functions provided by these resellers or the producers themselves.

One problem with the location/quality differential between Cushing and the market center is that it fails to recognize quality differences between crude oil produced from various locations. Crude oil quality can vary substantially from lease to lease or from field to field. The most significant factors that affect crude oil quality are sulfur, API gravity, and viscosity. MMS has assumed the gravity difference is included in the spot price differential between trading centers. However, MMS has overlooked the significant adjustment required for gravity banks which exist to compensate for the commingling of compatible but dissimilar crude oil types upstream of market centers. A gravity bank is a zero sum calculation whereby individual shippers either make payment to the bank or receive payment from the bank, depending on the difference in the gravity of the crude oil they are shipping and the weighted average gravity of the common stream. Adjustments vary depending on whether the bank uses fixed differentials, market-based differentials, or product value differentials. Gravity bank debits/credits are actual costs which vary from month to month and must be accounted for in determining quality/location differentials.

MMS' proposed methodology must include an adjustment for gravity if the royalty value is to approximate the value at the lease. Currently, gravity adjustments, which vary from $.02 per degree to $.20 per degree depending on location and type of crude, are based on the gravity deduction scales on the posted price bulletins, as developed by the refining industry to account for the inherent differences in yield value as quality factors change within a specific crude type. MMS must include gravity and sulfur adjustment scales to acknowledge the differences in quality.

Market Center v. Aggregation Point

The second location/quality differential is intended to account for the difference in value between the market center and the aggregation point. Marathon has identified several problems with this adjustment as proposed.

First, MMS' proposed methodology uses the location/quality differential under a producer's arm's-length exchange agreement if it includes an identifiable location/quality differential for the crude oil value difference between the market center and the aggregation point. MMS assumes that most exchange contracts call for the crude to be sold at the aggregation point and bought back at the nearest market center. This is often not the case. Crude oil exchange contracts often provide for the buy side of the transaction to be one of various types of crude at a number of possible locations, or even a combination of crude types and locations. Under some exchange agreements, the producer and seller mutually agree each month on where crude will be bought back. Under other contracts, either the seller or the buyer decides where the delivery point will be. In either case, the agreement provides for the price differential at each possible point of settlement. Under these complex scenarios, it would be virtually impossible to determine a location/quality differential between the aggregation point and the market center.

Second, MMS proposes publishing location/quality differentials for use by producers which do not dispose of crude oil under arm's-length exchange agreements containing express differentials. Marathon has numerous concerns with this proposal in general and with Form MMS-4415 in particular. Marathon's comments regarding Form MMS 4415 are discussed elsewhere. This section addresses Marathon's concerns in general.

Whatever value MMS develops as a cost from a market center to an aggregation point will be an imputed average, a calculated number that could possibly have no resemblance to actual costs. Lessees and shippers would file their differentials (gravity, sulfur, and transportation) between various points annually for MMS to calculate a published rate for lessees to apply to index prices. This rate will penalize lessees whose costs are above average and reward lessees whose actual costs are below average. A published one-size-fits-all rate for gravity, sulfur, and/or transportation disregards what may actually be obtainable in a free market situation.

Among the concerns presented by MMS' proposed rule are those involving pipeline capacity constraints. Reasonable, published, one-size-fits-all location/quality differentials would be extremely difficult to determine under the best of situations. However, the reality is the oil industry does not operate in a perfect world. Operational problems such as failures or bottlenecks often force pipeline operators to prorate space on the pipelines. Shippers are then forced to find alternative transportation and/or markets for their crude. For example, if the pipelines are full, a shipper wanting to transport its crude oil production from Midland to Cushing may be forced to find an alternative market in the Midland area or divert its crude to the Gulf Coast market. In either case, the shipper could incur higher transportation costs and receive a lower value for its crude oil. In this situation, the producer may use a different aggregation point or market center than usual and incur higher transportation costs in the process. The proposed regulations do not have the flexibility to account for this situation.

Proposed Form MMS-4415

MMS' proposed Form MMS-4415 raises some very serious concerns regarding the issue of confidentiality. As proposed, federal lessees would be required to submit proprietary contract information to MMS for use in determining the location differentials needed for its valuation scheme. However, MMS has given absolutely no indication as to how it would protect the confidentiality of each lessee's contract information. Any scenario that involved the filing of sensitive contract pricing data with MMS would surely have to be subject to confidentiality. Yet, the existence of this requirement would preclude a federal lessee from verifying the accuracy and integrity of the data compiled and published by MMS. Under no circumstances should MMS be granted the authority to require a federal lessee to base its royalty payments on unverifiable pricing sources. For this reason alone, the proposed Form MMS-4415 is a completely unworkable option.

The method MMS proposes to use for calculating location and quality differentials is also unacceptable in that it offers no assurances to a lessee that the results of this process will reflect actual market

conditions. First, by excluding from its calculations all transactions executed by non-federal lessees, MMS wrongly assumes it can somehow accurately determine market conditions based on data from only a portion of the overall market. Second, a lessee would be required to value its current-year royalty obligations using price differentials calculated from contracts negotiated during the previous year. As a result, a lessee's December 1997 MMS royalty value would be impacted by market conditions that existed as far back as January 1996, a full 23 months prior to the date of the lessee's liability. This timing problem could be detrimental to MMS in times of declining transportation costs, but since most such costs increase over time, lessees will bear most of the burden of reliance on outdated transportation costs.

Furthermore, MMS needs to redefine the situations in which a lessee would be required to submit the proposed Form MMS-4415. For instance, there are large geographical areas in which there is little or no federal acreage (e.g., Texas). Surely, MMS must realize that requiring a lessee to submit contract data related to non-federal areas creates an unnecessary administrative burden for no clear purpose. Marathon also questions MMS' authority to require lessees to provide this information for non-federal leases.

Another concern regarding the proposed Form MMS-4415 is the heavy administrative burden that would be imposed on federal lessees. MMS' estimate of the time and expense needed to complete the form is substantially understated. The degree to which it has been understated will depend upon MMS providing answers to the following questions:

- Is it MMS' intent to require lessees to report only information on exchanges between an aggregation point and a market center? If so, the proposed rule is unclear and MMS could receive significant amounts of meaningless data regarding other types of exchanges.

- The preamble to the proposed rule states, "Proposed Form MMS-4415, Oil Location Differential Report, would capture location differentials in all exchange agreements or other oil disposal contracts." (62 FR 3749) What does MMS mean by "other oil disposal contracts"? Is a company required to complete this form for oil sold outright at the lease to a third party? Would lessees be required to complete the form for transactions involving non-produced oil (e.g., oil purchased and then resold or exchanged)?

- What guidance will be provided on how to correctly fill out the forms? Companies may interpret the form differently and thereby cause MMS' calculation to be skewed.

There are a number of other questions regarding the proposed Form MMS-4415 that MMS needs to answer:

- How is MMS going to aggregate the collected data to determine the published location/quality differential? What is the formula/methodology to be used? Will MMS use a simple average, a volume weighted average, a median price, or some other calculation? Is a single reported transaction sufficient to establish a location/quality differential, or is a minimum number of transactions required?

- Does MMS need all the detail requested to determine the differentials?

- How will MMS eliminate the duplicate information received on exchange agreements from both the buyer and the seller? A simple comparison of the contract numbers will not necessarily be sufficient, as each party would likely report its own contract number.

- Are these forms subject to audit by MMS?

- What action would MMS take if it discovered an error in the calculation of a published differential? Would a revised differential be published, and the lessees required to submit revised Forms MMS-2014 to pay additional royalties or recoup an overpayment?

Transportation Issues

Marathon is strongly opposed to MMS' proposal to disallow the use of FERC tariffs in the determination of a lessee's non-arm's-length transportation deductions. To support its proposal, MMS cites the *Oxy Pipeline, Inc.* decision in which FERC renounced jurisdiction under the Interstate Commerce Act (ICA) over pipelines transporting oil solely on or across the Outer Continental Shelf (OCS). However, the assertion made by MMS that the *Oxy* decision means the use of FERC tariffs is no longer a viable alternative for determining non-arm's-length transportation allowances is not supported by the facts. On January 18, 1997 (six days before MMS published its proposed oil valuation rule), MMS' Associate Director issued a decision in response to the numerous appeals filed by lessees challenging MMS' denial of requests to use FERC tariffs as allowable non-arm's-length transportation allowances on OCS pipelines. The Associate Director concluded that MMS had improperly interpreted the *Oxy* decision, stating "although FERC has already made a generic jurisdictional determination in Oxy for all pipelines that transport production solely on or across the OCS, that determination cannot be expanded to serve as a jurisdictional determination for all OCS pipelines under all circumstances." (Marathon Oil Co., MMS-95-0232-OCS (January 18, 1997)) (emphasis added). In other words, FERC jurisdiction under the ICA must be determined on a case-by-case, pipeline-by-pipeline basis. The Associate Director went on to state, "provided that a company filed its rate with FERC and that FERC had jurisdiction over the rate, then it would be considered 'approved' for the purposes of the MMS' allowance determinations." Therefore, it is inaccurate for MMS to state, as it did in the instant notice of proposed rulemaking, that the issue of FERC jurisdiction under the ICA over OCS pipelines has been resolved. Furthermore, MMS' transportation proposal, as currently written, would also prevent an onshore federal lessee from basing its non-arm's-length transportation allowances on a FERC tariff even though the issue of FERC jurisdiction under the ICA regarding onshore pipelines is not in question.

Elimination of the use of FERC tariffs for determining allowable transportation deductions would also significantly increase the administrative burden for MMS and federal lessees. At the time the current transportation regulations were developed, there was a general consensus that the estimated cost versus actual cost adjustments contemplated by MMS would be a large burden on both industry and MMS. By accepting FERC tariffs, MMS eliminated the need for many retroactive adjustments. Furthermore, MMS previously concluded it is unnecessarily burdensome and duplicative to require a lessee to recompute costs for MMS transportation allowance purposes if it had already done so in a tariff filing with FERC. (53 FR 1221) Also, MMS would have to expend considerable resources to audit actual costs if it disallowed use of FERC tariffs. Yet, aside from its misplaced reliance on the *Oxy* decision, MMS has offered absolutely no justification for its decision to impose this unnecessary burden on federal lessees and itself.

A FERC tariff has long represented the recognized cost of a particular transportation service and, as a result, has been accepted by MMS as a proper transportation deduction. Pipeline companies do not necessarily maintain the supporting cost information in the format required by MMS and the allocations of overhead, depreciation, and other costs would be difficult, burdensome and could result in incomplete or invalid results. Additionally, those pipeline companies which are common carriers are subject to restrictions regarding the disclosure of confidential information designed to protect the rights of their shippers. Under any new oil valuation rule adopted by MMS, FERC tariffs must continue to be accepted as a valid basis for a transportation allowance irrespective of whether the transportation arrangement is deemed to be arm's-length or non-arm's-length.

The proposed transportation regulations would also serve as a disincentive for companies to build and operate crude oil transportation facilities. Under the proposed rule, a lessee would be required to determine the value of all of its non-arm's-length transportation services based solely on internal cost

accounting plus a nominal return on its undepreciated capital equipment. Any regulation which would, in effect, force a company to transport the federal lessor's share of production virtually at cost would adversely impact the transportation system's economics. To be fair and equitable, MMS' transportation regulations must provide for a complete recovery of all direct and indirect costs, including interest costs on capital investments, along with an acceptable profit for assuming the risks involved in performing a transportation service. By equating these risks with a secured debt instrument (i.e., S&P BBB industrial bond), MMS is being both unrealistic and unfair. MMS must recognize that capital will be expended for transportation assets only if the potential rewards exceed the risks.

Pipeline losses not attributable to negligence which occur between the royalty settlement point and the actual delivery point are a part of the transportation costs over which lessees have no control and, therefore, should be an allowable component of transportation deductions. Line losses are currently allowed as deductions to the extent they are quantified in an arm's-length contract or a FERC tariff. Yet, the proposed regulations do not permit the inclusion of line losses in the calculation of transportation allowances on producer-owned lines. If MMS does not absorb its share of all costs resulting from line losses occurring under both arm's-length and non-arm's-length situations, an inequity results.

MMS' current regulations limit the amount of transportation charges a lessee may deduct to no more that 50% of the product's lease value. However, under MMS' proposed method for determining the actual transportation costs incurred from the lease to either an aggregation point or an alternate disposal point, there is no longer a direct relationship between value at the lease and transportation costs. Therefore, MMS must eliminate this arbitrary limitation on transportation deductions from any index-based valuation rule.

The provision in the proposed transportation regulations which states that the allowance would terminate at the aggregation point or market center needs further clarification. MMS must address the situation where, in the process of transporting lease production to an alternative disposal point (e.g., a refinery inlet), a lessee moves the crude oil through an MMS-designated market center that is other than the market center used for valuation purposes. For instance, in MMS' example involving the movement of Wyoming Sour crude oil to a Salt Lake City refinery (62 FR 3748), MMS states that West Texas Sour crude at Midland, Texas represents the crude oil/market center combination nearest to the oil produced. MMS further explains that the lessee would be entitled to an allowance for all transportation costs incurred from its lease in Wyoming to its refinery in Salt Lake City. To be fair and equitable, the same allowance (i.e., the total transportation costs incurred from the lease to the refinery) must be granted to a lessee transporting its Wyoming Sour crude oil through Guernsey, Wyoming to a refinery in the Midwest.

Finally, the proposed regulations allow for the deduction of actual transportation costs from the lease to an aggregation point. However, if a producer sells its production outright at the lease, there are no out-of-pocket transportation costs. Does this mean a lessee who is required to use index-based pricing is not allowed to claim a transportation allowance? If not, MMS has essentially moved the valuation point from the lease to the aggregation point in violation of 30 CFR 206.103(a)(1). If so, how would the transportation allowance be calculated? What rate would be used?

Wyoming Example

Marathon has serious concerns with the Wyoming Sour example used by MMS to illustrate its proposed index-based methodology.

In its proposed regulations, MMS defines like-quality oil as "oil with similar chemical, physical, and legal characteristics." (62 FR 3748) In the very next sentence MMS states, "West Texas Sour and Wyoming Sour, in and of itself, would be like-quality." (62 FR 3748) Marathon disagrees. The term "sour" does not make crude comparable. Wyoming Sour and West Texas Sour crude oils bear no resemblance to

each other in terms of quality, end-user access, or liquidity. Wyoming Sour crude is a unique commodity which is divided into heavy asphaltic and general sour crudes. Marathon's Wyoming fields are concentrated in the Big Horn Basin, a producing region known for asphaltic crude, otherwise referred to as Wyoming black oil.

The concentration of sour crudes, especially the heavy asphaltic crudes, limits the number of market alternatives, as not all of the regional refineries can handle asphaltic crude. The demand for asphaltic crude oil is seasonal; it peaks in the spring and summer to accommodate increased road maintenance and road construction activity. Refiners plan well in advance and typically seek long term supply contracts to ensure they will be able to satisfy marketing demands. Wyoming producers also prefer long term marketing arrangements as a means of managing price risk and ensuring asphaltic production will not become distressed in the Rockies during the winter. Pipeline constraints are common during the winter when cold temperatures make it more difficult to pump the heavy asphaltic crude. Long-term marketing arrangements may result in a lessee forfeiting the opportunity to achieve peak prices, but they provide producers and royalty owners, including MMS, with downside price protection during periods when refinery demand is low.

Another important factor in the Wyoming crude oil market which MMS failed to consider is gravity. Wyoming asphaltic crude has an API gravity of approximately 22 degrees and can range from 16 to 28 degrees API gravity. The gravity deduction for asphaltic crude is $.02 per degree down to 36 degrees, $.04 per degree between 35.9 degrees and 34 degrees, and $.20 per degree below 34 degrees. The low gravity of asphaltic crude results in pipeline gravity bank charges of $2.00 to $3.00 per barrel. By comparison, the gravity of the West Texas Sour stream at Midland is approximately 34 degrees, and the standard gravity deduction is $.15 per degree. MMS has ignored the difference in the gravities of the Wyoming and West Texas crude oils and incorrectly assumed this would be accounted for in the location/quality differential between West Texas Sour at Midland and West Texas Intermediate at Cushing.

MMS' proposed methodology cannot realistically be adapted to Wyoming due to the unique characteristics of its crude oil market. As illustrated above, the market in Wyoming is distinctly different from the West Texas market. Therefore, the price of West Texas Sour crude in Midland cannot possibly be valid for asphaltic crude in Wyoming. Also, there are no published spot market prices for Wyoming Sour (asphaltic or general) crude. Both of these factors indicate the value of Wyoming crude must be determined at the lease. Moreover, the total refinery demand for all crude oil types in the Rocky Mountain region exceeds regional production by approximately 100,000 barrels per day. This shortfall creates a competitive and dynamic market at the lease level. Integrated refiners, independent refiners and resellers compete aggressively to purchase lease crude. MMS needs to look to these transactions at the lease level to value its share of the crude oil production.

ANS - Alaska/California

MMS' proposal suggests that both California crude oil and Alaska crude oil be valued for royalty purposes based on the landed price of Alaska North Slope crude in California, adjusted for transportation and quality differences. Others may comment more extensively on the problems with valuing California crude oil under such a proposal (and there are many), but Marathon wants to explain to MMS the illogic of applying such a scheme to federal royalty oil produced in Alaska.

The total volume of crude oil produced from federal leases in Alaska is small, about 5,000 barrels per day. (Marathon's share is only about 300 barrels per day.) All of the producing federal leases in Alaska are in the Cook Inlet area, and all of the oil produced from those leases is delivered to the Tesoro refinery located at Nikiski, Alaska where it is refined. Tesoro then sells the refined products in the local Alaska market. Thus, it makes no sense to value the oil produced from the federal leases in the Cook Inlet area (which moves only a few miles from the point of production to the Tesoro refinery) by looking to sales of oil in California. Moreover, the Cook Inlet oil produced from federal

leases is qualitatively quite different from the Alaska North Slope crude delivered to the West Coast. Thus, not only would theoretical transportation costs have to be calculated and deducted, but quality adjustments to account for the considerable differences between North Slope crude and Cook Inlet crude would also have to be made.

In short, MMS' proposal for valuing its modest volumes of royalty oil produced in Alaska suggests the agency has very little knowledge of the costs and risks associated with shipping crude oil from the Cook Inlet to the West Coast. Therefore, Alaska lessees should be allowed to utilize the price received for the sale of the Cook Inlet crude oil as the royalty value of the oil.

True-up to Gross Proceeds

Marathon does not believe the proposed oil valuation regulations provide fairness or certainty to federal lessees or MMS. However, if such a rule is promulgated, MMS must forego any "true-up" process that would allow it to revert back to a gross proceeds methodology if and when it is to its benefit to do so. Additionally, the proposed rule must include a waiver of the use of gross proceeds, including the gross proceeds provision of federal oil and gas leases. Any index-based valuation rule must clearly state that the value derived from a required index valuation procedure is the proxy for gross proceeds.

Non-Lessee Payor Problems

MMS' proposed rule fails to address the issue of royalty valuation when a royalty payor other than a lessee reports royalties on behalf of a lessee. For example, a non-lessee may purchase a federal lessee's production and pay the related MMS royalties or a lessee/operator may purchase additional lease volumes from other working interest owners and report MMS royalties on both its equity and purchased volumes. The proposed rule, as currently written, is unclear as to what MMS would require of the royalty payor in these situations. However, it is inconceivable that a royalty payor would somehow be expected to know each and every month whether any of the lessees for whom it reports royalties had purchased oil at any time during the past two years.

Unclear Reference in Preamble

The preamble to the proposed rule explains changes to 206.102(e). In doing so, references are made to proposed sections 206.102(e)(1), (e)(2) and (e)(3); however, there is no proposed paragraph 206.102(e)(3) in the rewritten sections. Is the preamble incorrect or is the provision incorrect?

PROPOSED ALTERNATIVES

The primary reasons offered by MMS for adopting an index-based valuation rule are (a) posted prices frequently do not reflect market value and (b) multiple dealings between crude oil buyers and sellers tend to make their contractual price terms suspect. However, instead of replacing the current regulations with a burdensome valuation scheme, MMS should consider the following alternatives to the proposed rule.

Royalty-in-Kind

MMS currently has the option of taking its royalty oil in-kind as opposed to in-value. By exercising this option and marketing its royalty share, MMS would eliminate the need for the lessee to contend with valuation issues. MMS conducted a series of public meetings during March and April of this year in Houston, Casper, and New Orleans to discuss and review possible options for a major royalty-in-kind pilot. Industry representatives provided considerable feedback to MMS that a successful royalty-in-kind program did not need to be complicated. If MMS were to take its royalty oil in-kind at or near the point of production, MMS would itself totally control valuation of its share of production, and a federal lessee

would only be required to report production volumes. Traditionally, volume audit issues have proven to be much easier and quicker to resolve than those arising from valuation. MMS could then contract with a few companies with production and marketing experience to further market the royalty oil downstream of the lease. In the public meetings, MMS acknowledged that by taking on the additional costs and risks downstream of the lease, they could generate additional value. The marketing agents would sell the oil for the best possible price and would pay MMS for its barrels at the sales price minus associated expenses and a negotiated marketing fee. MMS staff would not need to be involved in the marketing process.

This alternative, if kept simple, could dramatically reduce the administrative burden placed on both federal lessees and MMS. It would also alleviate MMS' primary concern expressed in the notice of proposed rulemaking by reducing the reliance on oil posted prices for valuation.

Modification and Enforcement of Current Regulations

Another way to address MMS' concerns is to identify where the current regulations might allow a lessee to pay royalties at less than true market value and rewrite those sections to better ensure MMS' interests are protected. Marathon suggests replacing various references to "posted price" in 30 CFR 206.102(c) with terms such as "gross proceeds accruing," "arm's-length contract price," or "market price at the lease." Particularly, MMS could eliminate the second non-arm's-length benchmark which allows for royalties to be valued on the basis of an average of contemporaneous posted prices. Unlike MMS' proposed rule, these changes would address MMS' major concerns while maintaining reliance on the benchmarking system and the key principle that royalty value is best determined by the interaction of competing market forces at the lease.

CONCLUSION

The proposed rule is based on a series of false market assumptions rather than on the fundamentals and dynamics of the crude oil market at or near the lease. An index-based valuation scheme such as the one proposed by MMS sacrifices the concepts of fairness, simplicity and certainty to the federal lessee by mandating the use of a royalty value derived from a government-created formula rather than determined by the marketplace. In addition to creating economic inequities and uncertainties for federal lessees, the proposed rule would require most federal lessees to incur significant administrative costs in order to comply with the new reporting requirements. No oil valuation rule based on a contrived formula can fairly and accurately measure the complexities and risks which confront federal lessees in today's domestic crude oil market.

For these reasons, Marathon recommends MMS withdraw the proposed rule and seriously consider the alternatives proposed by Marathon: solve the short-term valuation reliance on posted price terminology by modifying and enforcing the current regulations, and develop a long-term solution to the valuation issue by implementing a royalty in-kind program.

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